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Fed Cuts Outlook For Economic Growth Amid Credit Crunch

By Greg Ip
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The U.S. faces an unwelcome combination of looming recession and persistent inflation that is reviving angst about stagflation, a condition not seen since the 1970s.

Inflation is rising. Yesterday the Labor Department said consumer prices in the U.S. jumped 0.4% in January and are up 4.3% over the past 12 months, near a 16-year high. Even stripping out sharply rising food and energy costs, prices rose 0.3% in January, driven by education, medical care, clothing and hotels. They are up by 2.5% from the previous year, a 10-month high.

The same day brought a reminder of possible recession. The Federal Reserve disclosed that its policy makers lowered their forecast for economic growth this year to between 1.3% and 2%, half a percentage point below the level of their previous forecast, in October. They blamed a further slowdown on the slump in housing prices, tighter lending standards and higher oil prices. They warned the economy's performance could fall short of even that lowered outlook.

Stocks fell on the Labor Department's morning inflation report. But shares rallied after the afternoon release of the minutes of the Jan. 29-30 meeting of Fed policy makers and their latest forecast for the economy. That's because investors took the Fed's darker outlook on growth to mean that it intended to cut its short-term interest rate next month at its next scheduled meeting.

A simultaneous rise in unemployment and inflation poses a dilemma for Fed Chairman Ben Bernanke. When the Fed wants to fight unemployment, it lowers interest rates. When it wants to damp inflation, it raises them. It's impossible to do both at the same time.

Stagflation, a term coined in the United Kingdom in 1965, defined the years from 1970 to 1981 in the U.S. Inflation rose to almost 15%. The economy went through three recessions. Unemployment reached 9%. Fed Chairman Paul Volcker finally conquered inflation, but only by dramatically boosting interest rates, causing a severe recession in 1981-82.

Today's circumstances are far from that. Inflation is lower. Unemployment has risen, but only to 4.9%.

Yet there are similarities. As in the 1970s, surging commodity prices are leading the way. Crude oil rose to $100.74 a barrel yesterday, a new nominal high and close to its 1980 inflation-adjusted high. Wheat prices have hit a record. And, as in the 1970s, the rate at which the U.S. economy can grow without generating inflation has fallen, because of slower growth in both the labor force and in productivity, or output per hour of work.

The biggest difference is that in the 1970s, the Fed was unwilling, or thought itself unable, to bring inflation down. The Fed today sees achieving low inflation as its primary mission.

'Suffer for a While'

"The reason we're so unlikely to see a repeat is we're not adding irresponsible policy," says Christina Romer, an economist at the University of California at Berkeley and a historian of Fed policy. That means if the Fed is wrong in thinking inflation's recent rise is temporary, it will tolerate economic weakness in order to get inflation down again. "They'd have to let us suffer for a while."

Indeed, in minutes to officials' Jan. 29-30 meeting, released yesterday with the customary three-week lag, some officials noted it was important not to lose sight of controlling inflation. They argued that "when prospects for growth had improved, a reversal of [some rate cuts], possibly even a rapid reversal, might be appropriate."

But that does not seem imminent. Officials said keeping interest rates low "appeared appropriate for a time," implying Fed officials felt little urgency to reverse recent cuts. Even after the January meeting's half-point rate cut, to 3%, "downside risks" to the economy remain, they said.

The inflation picture makes steep rate cuts a riskier way to rescue the economy than when former Fed Chairman Alan Greenspan delivered them in 2001. Stephen Cecchetti, an economist at Brandeis University, said the Fed is now torn between its dual responsibilities of keeping unemployment down and prices stable. "The primary objective has to be to shore up the financial markets" to protect the economy, he said. "Then, once you're finished, come back and start worrying about inflation."

Members of the Federal Open Market Committee, the Fed's policy committee, raised their forecasts for both the overall inflation rate and the "core" rate, which excludes food and energy, by 0.3 percentage points from October, their latest forecast revealed. Yet they dialed back their rhetorical concern. The officials pronounced risks on inflation to be "balanced" -- in other words, they felt inflation, should it differ from their forecast, was as likely to be lower as it was higher. In October, by contrast, they suggested that, if inflation was to differ from their forecast, they expected it to be higher. That's principally because they see unemployment remaining higher for longer than they did in October, and expect that to help contain price increases.

Higher inflation is still a possibility. Food and energy costs could keep rising, instead of flattening out as futures markets currently anticipate. Companies could succeed in passing those costs onto consumers.

Sara Lee Corp. this week told analysts it expects to recoup rising raw-material costs in part by raising prices, especially on bread. Company spokesman John Harris said Sara Lee's significant competitors had matched the increases, with consumers showing no sign of trading down to lower-cost brands. "With commodities reaching unprecedented levels," Mr. Harris said, "it is quite likely we will take pricing up again."

Goodyear Tire & Rubber raised the price of replacement tires 7% on Feb. 1, on top of two increases totaling 11% last year. Chief Financial Officer Mark Schmitz told analysts last week that the hike was the result of rising prices of key raw materials, according to a transcript by Thomson Financial. Mohawk Industries Inc. raised carpet prices in December and again in January because of rising material costs, even though sales have been hurt by the slumping housing market.

The declining dollar, while boosting U.S. exports, is adding to inflation pressure, as goods priced in foreign currencies become relatively more expensive. Prices for imports from China jumped 0.8% in January, the largest monthly increase since the Labor Department began reporting the data in 2003.

British Parliamentarian Iain Macleod is credited with first using the word stagflation in 1965. "We now have the worst of both worlds -- not just inflation on the one side or stagnation on the other, but both of them together. We have a sort of 'stagflation' situation."

In the U.S., stagflation scares are more common than actual stagflation. Core inflation rose after the start of recessions in both 1990-91 and 2001, but then trended down as unemployment kept rising.

The only generally agreed period of stagflation in the U.S. came in the 1970s. Its seeds were planted in the late 1960s, when President Johnson revved up growth with spending on the Vietnam War and his Great Society programs. Fed Chairman William McChesney Martin, meanwhile, failed to tighten monetary policy sufficiently to rein in that growth.

In the early 1970s, President Nixon, with the acquiescence of Fed Chairman Arthur Burns, tried to get inflation down by imposing controls on wage and price increases. The job became harder after the Arab oil embargo dramatically drove up energy prices, and overall inflation, in 1973. Mr. Burns persistently underestimated inflation pressure: In part, he did not realize the economy's potential growth rate had fallen, and that an influx of young, inexperienced baby boomers into the work force had made it harder to get unemployment down to early-1960s levels.

As a result, even when he raised rates, pushing the economy into a severe recession in 1974-75, inflation and unemployment didn't fall back to the levels of the previous decade. Mr. Burns and his colleagues wrongly concluded inflation no longer responded to the condition of the economy, said Ms. Romer, the Berkeley economist. "They didn't know how the world worked," she said.

Political Environment

In a speech in 1979, a year after he stepped down, Mr. Burns blamed his failure on a political environment that wouldn't tolerate the high interest rates necessary to rein in inflation. As the Federal Reserve tested how far it could raise rates, he said, "it repeatedly evoked violent criticism" from the White House and Congress.

Such political risks are smaller but not entirely absent for Mr. Bernanke in this election year. On Sunday, the likely Republican presidential candidate, Sen. John McCain, told ABC's "This Week": "I would have liked to have seen faster rate cuts and earlier than they were done by him." Asked if he would reappoint Mr. Bernanke when his term expires in 2010, Sen. McCain said, "I would have to consider that at the time."

Still, Mr. Bernanke has reiterated the importance of not repeating the 1970s. He and his colleagues believe a persistent escalation of inflation is likely only if workers and firms come to expect the elevated inflation rate to persist, and set their wages and prices accordingly.

"Any tendency of inflation expectations to become unmoored -- or for the Fed's inflation-fighting credibility to be eroded -- could greatly...reduce the central bank's policy flexibility" to support growth with lower interest rates, he told Congress last week.

That credibility could be endangered by the Fed's recent track record. Yesterday's forecasts show that FOMC members define price stability as inflation of 1.5% to 2%, measured by an index that differs slightly from the commonly cited consumer-price index. By that measure, inflation has averaged 2.8% since mid-2004, when oil began a multiyear surge. Core inflation, which excludes food and energy, has averaged 2.2%.

Thus far, Fed officials have taken comfort that surveys and bond-market behavior suggest the public expects the inflation rate to fall. But expected inflation, as measured by trading of inflation-protected Treasury bonds, has jumped since the Fed declared in early January that supporting growth would be a more important focus than holding down inflation. (Fed officials believe technical details in the way the bonds trade may explain some of the jump.) And professional forecasters surveyed by the Federal Reserve Bank of Philadelphia recently nudged up their expected inflation rate for the next 10 years to 2.5% from 2.4%, where it had stood all last year.

On the other hand, surveys of consumer predictions about inflation show no corresponding jump. And most important, wage gains have not accelerated. Since labor is the largest component of business costs, a wage-price spiral would likely be a prerequisite for stagflation.

"We're a very, very long way from the 1970s," former Treasury Secretary Lawrence Summers said in an interview yesterday. A hit to overall spending, as has resulted from the current tightening of lending conditions, first affects production and employment, and only later inflation, he said. "But obviously, inflation figures need to be monitored very closely."